Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Senate Rev. & Tax. Committee   Analyst: Marion Mann DeJong   Bill Number: SB 1061

Related Bills: See Prior Analysis   Telephone: 845-6979   Amended Date: 09/04/2003

Attorney: Patrick Kusiak   Sponsor: ______

SUBJECT: Water's-Edge Election Procedures/Definition of "Taxable Year" for Calendar or Fiscal Years Beg. on or after January 1, 2000/Exempt Orgs./Apps. for Exemption or Amending Articles of Inc./"Corporation" Includes LLC

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ______________.

____ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ______________.

____ FURTHER AMENDMENTS NECESSARY.

__X__ DEPARTMENT POSITION CHANGED TO PENDING.

__X__ REMAINDER OF PREVIOUS ANALYSES OF BILL AS INTRODUCED FEBRUARY 27, 2003, AND AS AMENDED JUNE 30, 2003, STILL APPLY.

____ OTHER - See comments below.

SUMMARY

This bill would:

1. Add a definition of the term "taxable year" for California franchise tax purposes that was inadvertently repealed for taxable years beginning on or after January 1, 2000.
2. Fundamentally reform the water's-edge election procedures to resolve problems that arise with elections made under the current contract rules. Under this bill, water's-edge elections would be made by statutory election rather than by contract.
3. Eliminate inconsistencies between the Corporations Code and the Revenue and Taxation Code (RTC) regarding the ability of a suspended corporation to apply for tax-exempt status.
4. Allow exemption from taxation for specified limited liability companies (LLCs).

The Franchise Tax Board is sponsoring the first three provisions summarized above.

SUMMARY OF AMENDMENTS

The June 30, 2003, amendments added the fourth provision, summarized above, related to LLCs.

The department's analyses of the bill as introduced February 27, 2003, and as amended June 30, 2003, still apply. The following discussion is added related to LLCs. The Board position is changed from support to pending, since the Franchise Tax Board voted on November 26, 2002, to sponsor only the first three provisions summarized in this analysis.

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Brian Putler	9/22/03
____ N	____ OUA	__X__ PENDING		

PURPOSE OF THE BILL

This bill is intended to:

1. clarify tax law,
2. ease taxpayer compliance and administrative burdens regarding water's-edge elections,
3. eliminate inconsistencies between the RTC and Corporations Code, and
4. exempt from taxation certain title-holding entities, thus reducing paperwork required from these entities and allowing these entities the flexibility to choose the most beneficial form of organization.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2003.

POSITION

Pending.

On November 26, 2002, the Franchise Tax Board voted to sponsor the first three provisions summarized above.

4. Limited Liability Companies (Sections 17941, 23701h, and 23701x)

ANALYSIS

FEDERAL/STATE LAW

Current federal and state tax law allows exemption from the income and franchise tax for certain organizations. These organizations include the following for-profit business entities:

- Single-shareholder corporations organized for the exclusive purpose of holding title to property, collecting income from the property, and transmitting the entire amount of income, less expenses, to another exempt organization; and

- Corporations or trusts that:

  1. Have no more than 35 shareholders or beneficiaries,
  2. Have only one class of stock or beneficial interest, and
  3. Are organized for the exclusive purpose of:
     (a) Holding title to property and collecting income from it, and
     (b) Remitting the entire amount, less expenses, to one or more organizations exempt from taxation, which are shareholders of the corporation or trust.

Current state law authorizes the creation of a business entity known as an LLC. An LLC consists of one or more members that may be individuals, partnerships, limited partnerships, trusts, estates, associations, corporations, other LLCs, or other business entities. The members of an LLC are afforded limited liability similar to shareholders of a corporation but have pass-through treatment for taxes comparable to the tax treatment of a partnership.

Under federal and state tax law, an LLC may elect to be treated as a corporation or a partnership. An LLC with a single member may be treated as a corporation or disregarded for income tax purposes. When an entity is "disregarded," its activities are deemed to be the activities of the owner (e.g., a sole proprietorship or a division of a parent company). Under Personal Income Tax Law (PITL), a tax and fee is imposed on every LLC not classified as a corporation that is organized, registered, or doing business in this state.

Under federal tax law, as stated in Announcement 99-102, 1999-43 I.R.B. 545, the Internal Revenue Service (IRS) treats a disregarded single-member LLC as part of its exempt owner for the purpose of exemption from federal tax on corporations. A separate application for exemption is not required.

California Legislative Counsel has issued an opinion concluding that a non-profit organization may not form and operate as an LLC.

<u>THIS BILL</u>

This provision of the bill would exempt from taxation an LLC that is a title-holding corporation under specified Internal Revenue Code sections, whether the LLC is classified as an association taxable as a corporation, a partnership, or a disregarded entity. Thus, a title-holding entity would have the flexibility to organize in the most advantageous form for its California activities.

<u>IMPLEMENTATION CONSIDERATIONS</u>

Implementing this provision of the bill would occur during the department's normal annual update.

LEGISLATIVE HISTORY

This provision of the bill is identical to the April 23, 2003, version of SB 1064 (Senate Revenue & Taxation Committee). SB 1064 was "gutted and amended" on September 4, 2003.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Massachusetts and *Minnesota* do not impose a tax on LLCs at the organization level.

Florida and *Illinois* refer to federal law regarding exempt organizations.

Michigan and *New York* impose a tax on LLCs at the organization and do not provide an exemption comparable to the exemption allowed by this bill. No laws were found where these states provide exemptions from tax for LLCs used as title-holding companies.

FISCAL IMPACT

This provision of the bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This provision of the bill would have no identifiable revenue impact.

Revenue Discussion

Neither the number of LLCs that are title-holding companies for tax-exempt parent organizations nor amounts of net income that would be otherwise taxable, if any, is known. Department staff believes that the tax-exempt organization community is well aware that an LLC for title-holding purposes is not currently exempt under California law. If this bill is enacted, department staff estimates the number of LLCs that could potentially qualify under this bill is very limited. To the extent there would be revenue losses in any given year, it would be "revenue by mistake." Revenue by mistake would result from an organization making a filing error, which could be corrected.

LEGISLATIVE STAFF CONTACT

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